

The Effect of Operational Risk Management (ORM) On The Financial Performance (FP) Of Iraqi Commercial Banks

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Abstract

A major concern for banking management was the increase in bank losses due to insufficient operational risk management and adverse repercussions on banks' financial performance. Hence, the purpose of the study to determine the effect of operational risk management on financial performance in commercial banks in Iraq.

A quantitative approach is used to obtain data from a survey (questionnaire) consisting of 30 items with a five-point Likert scale. A total of 126 managers participated from the commercial banks in the Iraqi banking sector in the study. Smart PLS 3.2.9 was used for data processing.

The empirical findings show that operational risk management is positively and significantly related to financial performance. The results support the hypothesis that operational risk management has a significant impact on the financial performance of commercial banks in Iraq.

This study recommends the banks should tighten its operational risk management systems in order to continue improving its financial performance. The Iraqi commercial banks should regularly study and assess their opportunities to achieve their financial objectives.

The study is based on a limited scope; therefore, larger sample size may make for interesting research in the future.

Keywords: financial performance, Iraqi commercial banks, operational risk management.

1. Introduction

Banks play an essential role in the development of any economy by facilitating businesses, trade, and ensuring judicious allocation of idle funds. Banks are also pivotal in the implementation of government monetary policies (Issn and Fadun 2020).

However, the inability of banks to meet its intermediation obligations introduces some vulnerability to the financial system. Indeed, some studies have demonstrated that insufficient administration of such vulnerabilities can fuel a sovereign debt crisis (Jongh et al. 2013).

Banks are vulnerable to two risk categories: financial and non-financial. Financial risks are a result of the business operations/transactions of the bank and can be further categorized into credit risk, and market and liquidity risk. Non-financial risk on the other hand impacts negatively on performance as a result of

management failure, competitions, external factors etc. Non-financial risks mainly include operational risk, strategic risk and compliance risks (Rasheed, Saeed, and Gull 2018).

Operational risk refers to the business' financial loss as a result of wrongdoing or inadequacy and is caused by external factors. Operational risk may be tangible in market disturbances, failures to manage, mistakes, misdeeds or external events. The International Settlement Bank, the central bank's main organization, based in Basel, Switzerland, has identified operational risk in the major economies of the world losses caused by insufficient or unsuitable internal procedures, entities, structures or outside events. The operational risk can be broken down into planned and unforeseen losses (Muriithi and Waweru 2017).

The core theme of operational management is similar to market, liquidity and credit risks,

which finds out the exposure of operational risk of financial institutions; to comprehend what drives it, to allocate capital against it and distinguish trends internally and externally that would help to predict it. There has been a growing interest in the subject of risk management across the world due to the number of economic events. These economic events showed the need for risk management activities in the context of repeated global financial crises (Ringim 2012).

The importance of operational risk management cannot be overemphasized as it will help to recognise banned activities easily, minimize potential risk exposure and contribute eventually to a reduction in operational losses (Habib et al. 2014). Despite the growing literature on the subject of operational risk management in developed economies, there is a notable lack of literature in Economies of developing countries like Iraq. Only a few studies (John et al., 2020; Muriithi & Waweru, 2017; Meshack & Mwaura, 2016; Oluwafemi, 2013) had examined risk management research with financial performance. In different countries, but None of these studies has examined the impact of (ORM) on (FP) in the Iraqi commercial banks.

The objective of this study is to provide empirical evidence of the extent to which operational risk management framework has impacted financial performance in the commercial banks in the context of developing countries like Iraq. Hence the research question that emanates from the objective is 'To what extent does operational risk management impacts financial performance in the Iraqi commercial banks?'

This study contributes to growing literature in the area of operational risk management research in Economies of developing countries.

The remaining part of this study is structured as follows: Section 2 provides an extant literature review on operational risk management and financial performance, and also the relationship between Variables and hypotheses. Section 3 deals with the model specification and data collection method. Section 4 the findings of the study, while Section 5 focuses on the conclusions,

Limitations and Future Research and recommendations.

2. Theoretical Framework

2.1 Operational risk management

There are ever threats and the likely consequences depend on the uncertainties. We accept various types of risks on a daily basis and then take some steps to control and minimize them. Risk reduction is characterized as the continuous cyclical process, including risk evaluation, risk decision-making and risk monitoring that results in risk acceptance or risk avoidance (Habib et al. 2014).

According to Okeke et al. (2018), The operational risk known as losses resulting from internal procedures, individuals and systems, or external incidents that are inadequate or defective. This definition contains legal risks and removes reputational and strategic risks.

The conventional phrase of operational risk is based on risk sources or events which cause the bank losses from its operational methods. Noted Tandon and Mehra (2017) that loss factors are frequent and severe for banks which results in a reasonably high incidence and severe failure.

In the service of financial institutions, and in particular for banks, risk management plays an important role. Risk management is a primary aspect of a successful organization. Effective risk management in financial institutions, coupled with strict conformance to good corporate governance are crucial factors to the success of the bank (Oblakovic 2013). When banks adopt sophisticated risk management practices as well as effective and sound management strategies, their chances of long-term survival are increased. The risk management process should be fully understood by the board of directors as well as all other employees for the organization to achieve any meaningful change (Adellah, 2019).

Operational risk management involves the analysis and mitigation of risks aimed at identifying and controlling hazards at all levels of the firm so as to lower risks to acceptable levels. A business risk analysis entails the

identification of the assets, the threats, the potential business impact in case of realized threats, and the vulnerabilities in the firm's protection. The business purpose of risk management is to reduce the firm's vulnerability through suitable controls on individual loss events, after consideration of security and costs. Such controls can be both technical and procedural and these must be integrated into the entire organization/business units (Bagherzadeh and Jöehrs 2015). also, (ORM) is integral to decision-making and successful risk management will help

address business failure possibilities proactively (Ndaiga 2016).

2.1.1 Dimensions of operational risk

Operational risk concept is based on the underlying causes of such risks and seeks to identify why an OR loss happened (Ong 2011). A causal based definition can be used by experts to identify, assess and manage operational risk (Zengin and Yüksel 2016). Figure 1 illustrates that a loss is caused by an operational event, which in turn is caused by four different factors: people, systems, processes, or external events (Chalupka and Těplý 2008).

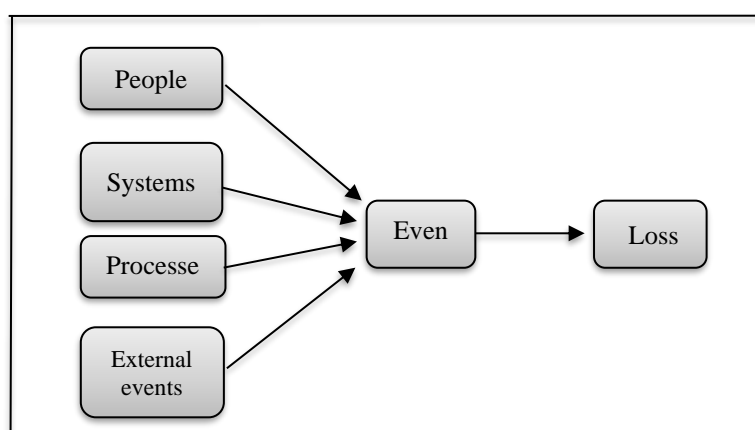


Fig. 1: dimensions of operational risk

Every principle of OR variable adopted as the basis of OR in financial institutions based on sources is defined as follows: (Bagherzadeh & Jöehrs, 2015; Savić, 2008; Xifra & Ordeix, 2009; Diaconu et al., 2017; Okeke et al., 2018).

2.1.1.1 People risk

Risk of People involves the possibility of loss connected with staff members' errors and unlawful acts, lack of training, unsuitable banking arrangement of their work, etc. Human error, poor preparation and staff control, lack of division of roles, lack of honesty, and dignity will often imply a risk for individuals.

2.1.1.2 System risk

IT applications in enterprise environments face obstacles, but may also contribute to risks, to the workflow, processes, and policies. The risks associated with IT, therefore, cannot be regarded independently, but only connected with individuals, processes, and other risks

associated. Issues in IT infrastructure triggered by malware, cyber-attacks, and other vulnerabilities contribute to serious issues that impact the whole organization. Process and technical risks may thus be viewed as the risk of losses attributable to insufficient banking systems, e.g., system capability weakness, persistent operational insufficiency, insufficient data processing techniques, low quality, or insufficiency of the data used. An appropriate IT review and monitoring would accomplish the efficient execution of the whole risk management system through the provision of IT security.

2.1.1.3 Process risk

Process risk is the possibility of a loss of processes linked to errors during operations, accounting, recording, pricing, measurements, etc. The risk covers the execution of transactions at all times and certain business administration elements, such as the risk for goods and services, inadequate monitoring

mechanisms, and a shortage of protection or a high degree of protection.

2.1.1.4 External risk

The risk of loss is external to the environment in which the bank operates due to changes in its environment. Changes in the law, politics, economy, and possibility of outside physical intervention are other main external risks.

2.2 Financial performance

Despite the essential importance of financial sustainability, the financial performance assessment has not been subject to a number of methodologies and choices (Al-basheer and Shawaqfeh 2015).

There was also the view that the majority of financial institutions in this sector were unsustainable. (Solomon et al. 2012). Studies have shown that this is primarily related to risk perception and lending of micro borrowers and the small loans economies of scale. Because of demonstrated viability and low operating costs, microfinance has attracted lending agencies. Liquidity tests the company's ability to fulfil its financial commitments when they occur without affecting the company's usual continuing operations (Bushara, Ahmed, and Elzebar 2018).

Structural and operating liquidity can be measured. Structural liquidity refers to the budget (assets while liabilities), and cash flow measures refer to operating liquidity (Kurdi, Naji, and Naseef 2019).

On the other Gadzo et al. (2019) indicated that solvency measures the amount of borrowed capital used by the business relative the amount of owners' equity capital invested in the business.

In other terms, solvency indicators reflect the ability of the corporation to repay the debt once all assets have been sold. Solvency metrics can provide an indicator of the business' risk tolerance capacity to continue its business activities after significant financial adversity by supplying information about its ability to continue operating (Al-basheer and Shawaqfeh 2015). Profitability measures to assess the degree to which a business produces profit from production factors: labour, management and capital. Profitability analysis focuses on the relationship between revenues and expenses and on the level of profits relative to the size of investment in the business (Abeysekara 2019).

The rates of return on assets, the equity rate (ROE), the margin of operating profit and net corporate income are four useful indicators of corporate profitability. The ROA calculates the return on all company assets and is often used as a profitability index and the higher the value, the more profitable the company will be.

The ROE calculates the return rate on the equity of the owner working in the business. It is useful to consider the ROE in relation to ROA to determine if the firm is making a profitable return on their borrowed money (Gadzo et al. 2019).

2.3 Relationship of (ORM) and Financial performance

Bank Management's main objective is to increase shareholder returns that reflect bank results.

The target also comes at the price of risking.

The bank faces various risks such as market risk, credit risk, operational risk, and liquidity risk. The bank's risk management motivation is motivated by the risks that can lead to bank failure (Abeysekara 2019).

Bank risk management impacts not only the bank but economic development as well (Adabenege et al. 2015).

Banks that handle the risk better can have some advantages: (i) It improves its prestige and the potential to draw broader clients. (ii) It increases their efficiency and profitability (Songling, Ishtiaq, and Anwar 2018).

On his study support the theoretical argument brought to light by that risk management in an organization influence the organization profitability, through enhanced risk management practices.

Meshack and Mwaura (2016) revealed that some risk management practices do have a significant effect on (FP) more than others i.e., the existence of a risk management policy and the integration of risk management in the setting of organizational objectives were considered to be the key RM practices that had a direct effect on (FP).

The findings revealed Issn and Fadun (2020) study that sound operational risk management practices impact positively on the (FP) of banks.

The study Isoh and Nchang (2020)

The financial efficiency has improved dramatically with the introduction of internal operative risk management techniques,

revealed that internal risk management activities and risk control, as well as training and reporting, have an important positive effect on financial performance.

Also, the study Muriithi and Waweru (2017) found that operational risk management practices influenced an effect on the profitability of commercial banks, hence affecting their financial performance.

This means the banks can boost their performance through the implementation of good policy risk management, even if other determinants do not form a part of the analysis. and integrating risk management in the process of setting achievable organizational objectives. Therefore, we propose the following main hypothesis:

H1: Operational risk management has a positive effect on financial performance.

H1a: People risk management has a positive effect on financial performance.

H1b: System risk management has a positive effect on financial performance.

H1c: Process risk management has a positive effect on financial performance.

H1d: External risk management has a positive effect on financial performance.

3. Methodology

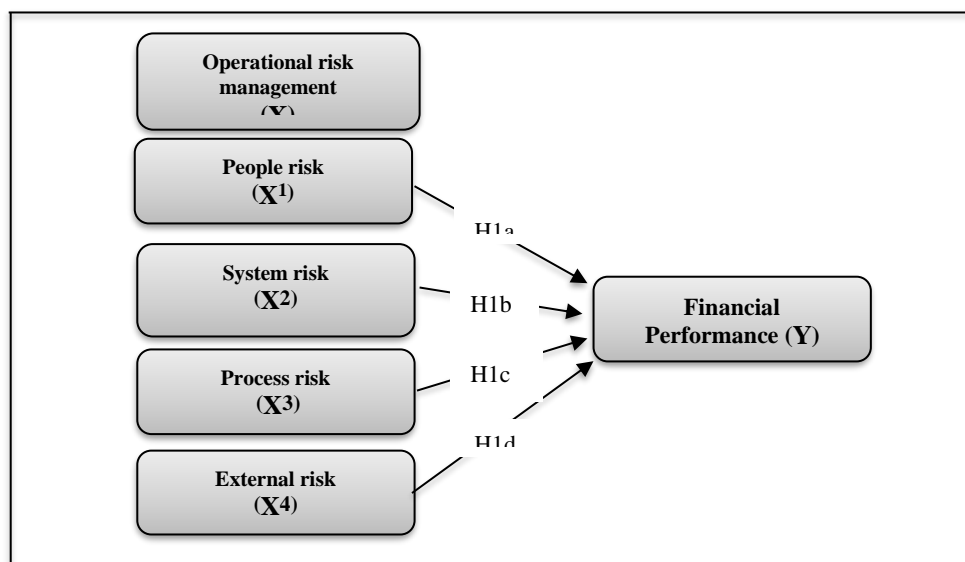
In this paper, an attempt was made to study the relationship between (ORM) and financial performance within the Iraqi commercial banks. A quantitative methodology was taken in which the data collected were separated into two sections by a survey. framework for this paper.

The first section focusses on the general features of the subjects, including age group, occupation, educational level, and Years of service. In the second section, measuring the components of operational risk management, and financial performance was our interest, a representative sample is crucial if evidence from the sample is being used to generalize the broader population from which the sample was chosen. The study was applied to a sample of (126) executives and heads of departments from the commercial banks. The participants were invited to give their opinions on a Likert-scale (1-5) ranged from "Extreme Disagreement" to "High Agreement to analyze data obtained using a Smart pls 3. Partial least square structural equation modelling is used to test the hypothesis. PLS-SEM technique is superior to other statistical methods in many ways such as effective for statistical model building along with forecasting, no sample size restriction, and suitable especially in case of mediation and precise and accuracy in estimation, soft modelling assumptions doesn't require normality of data (Hair Jr. et al. 2017).

3.1 Conceptual Framework

The conceptual framework of (Bani, Nordin, and Hanafi 2018) has an essential part in research to explain the methodology used for the study. A conceptual structure is therefore important to guide this research to its target. As seen in the figure. 2" ", the author has developed a clear conceptual

Fig. 2: Conceptual Framework



4. Empirical Results and Discussion

Table 1 shows the general characteristics of respondents, including gender, age, educational level, and years of service:

4.1 Profile of population

Table 11: Profile of population

Variable	Category	Frequency	Percentage %	Total sampling
Gender	Male	75	59.5	126
	Female	51	40.5	
Age	30-20	7	5.5	126
	40-31	31	24.7	
	50-41	68	53.9	
	50 And Over	20	15.9	
Educational	Diploma	13	10.3	126
	Bachelor	75	59.5	
	Master	29	23.1	
	Ph.D.	9	7.1	
Years of service	More Than 5-10	22	17.4	126
	More Than 10 -15	34	26.9	
	More Than 15-20	47	37.4	
	20 And Over	23	18.3	
Position	Executive Manager	25	19.8	126
	Department Director	101	80.2	

4.2 Convergent validity

Convergent validity is defined as "subcategories of construct validity", is assessed to validate the measurement model. Average Variance Extracted (AVE) is used to calculate the proportion of the Variance described by way of metrics for calculation errors. The lowest recommended reliability level is 0.7 based on the PLS review (Hair et al., 2017), And Average Variance Extracted (AVE) level 0.5 is the minimum acceptable

level. As seen in Table 2 and fig.3, composite reliability and Cronbach's Alpha are deployed to evaluate the internal consistency reliability of each dimension. If the alpha coefficient of each part of a building in general exceeds 0.7, the objects are considered highly trustworthy (Kannan and Tan 2005). The products were considered to be extremely accurate because the alpha coefficients of the individual Cronbach structures were over 0.7.

Table 2: The product of convergent variables of validity

Variables	Construct	Items	Outer Loading	Cronbach's Alpha	Composite Reliability	AVE
Operational Risk Management	People risk	PER1	0.946	0.935	0.951	0.798
		PER2	0.938			
		PER3	0.944			
		PER4	0.811			
		PER5	0.814			
	System risk	SYR1	0.854	0.882	0.913	0.679
		SYR2	0.805			
		SYR3	0.844			
		SYR4	0.823			

	Process risk	SYR5	0.791	0.929	0.946	0.779
		PRR1	0.900			
		PRR2	0.898			
		PRR3	0.831			
		PRR4	0.908			
	External risk	PRR5	0.874			
		EXR1	0.930	0.930	0.948	0.785
		EXR2	0.805			
		EXR3	0.939			
		EXR4	0.938			
		EXR5	0.806			
Financial Performance	Financial Performance	FP1	0.881	0.959	0.964	0.729
		FP2	0.851			
		FP3	0.852			
		FP4	0.891			
		FP5	0.864			
		FP6	0.815			
		FP7	0.835			
		FP8	0.877			
		FP9	0.875			
		FP10	0.792			

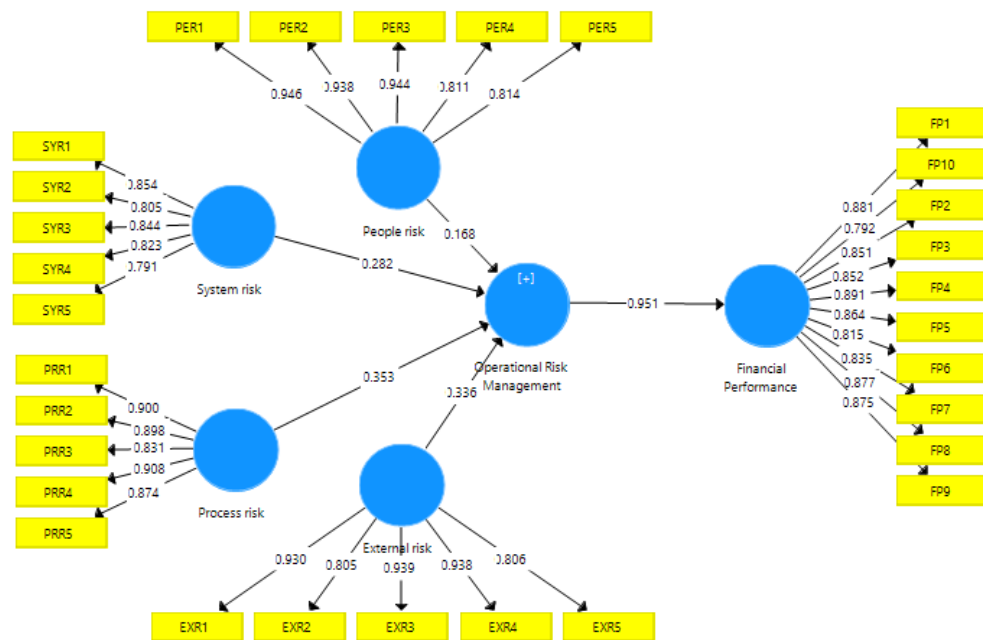


Fig.3: Model for measuring

As Table 3 reveals., the correlation of latent variables and discriminant validity (Fornell-Larcker) Squared correlations were lower than the corresponding AVE estimates between the variables. This finding indicates that the

constructs had a stronger relationship to their respective indicators; the result indicated that the measure had adequate discriminant validity.

Table 3: Correlation of latent variables and discriminant validity

Variables	PER	SYR	PRR	EXR	FP
People risk	0.835				
System risk	0.602	0.790			

Process risk	0.722	0.522	0.888		
External risk	0.654	0.589	0.612	0.843	
Financial Performance	0.665	0.439	0.482	0.523	0.892

4.3 Hypotheses Testing (Path Coefficient)

The final step in evaluating the structural model is examining the research hypotheses through assessing the path coefficient. The smaller the p-value, the stronger the

significance of the relationship will be (Hair et al., 2017). Table 4 shows below the direct relationship results of the structural model, the relationship between hypothesis as H1a, H1b, H1c, H1d.

Table 4 Direct results of hypotheses

Hypothesis	Path Coefficient	Std. Error	T-value	P-value	Inference	Decision
H1a – PER > FP	0.159	0.022	7.250	0.000	Significant **	Supported
H1b – SYR > FP	0.268	0.012	22.586	0.000	Significant **	Supported
H1c – PRR > FP	0.335	0.013	25.513	0.000	Significant **	Supported
H1d – EXR > FP	0.319	0.012	25.621	0.000	Significant **	Supported

The important information presented in Table 4 of transactions is the statistical significance of the dependent variable. The value of p tells us if the coefficients of the variables are zero in the population. If p is less than 0.001, We may conclude that the variables are statistically significant. In our case, we may see from the table that all independent variables have a positive effect and that the p-values for all independent variables are less than 0.01. Hence, a reasonable conclusion can state that a significant and positive impact, and we reject our empty assumptions and thus support the assumptions:

H1a: There is a positive relationship between people's risk management and financial performance.

H1b: There is a positive relationship between systems risk management and financial performance.

H1c: There is a positive relationship between process risk management and financial performance.

H1d: There is a positive relationship between external risk management and financial performance.

4.4 Discussion

From the summary of findings, it is clearly evident that the (ORM) had an effect on the financial performance of commercial banks in Iraq. The study found that the four independent variables in the study (People risk, System risk, Process risk and External risk) influenced (FP).

These results are consistent with the Lyambiko (2015) who is studying the effect of Operational efficiency on the (FP) of commercial banks in Nigeria established that various Operational efficiency actions instituted in the country have influenced the efficiency of the banking sector directly and indirectly in a variety of respects over the years and include profitability in banks, loans/advances deposits mobilization and so on.

This finding further supports the results of the research by (Oluwafemi, 2013; Meshack & Mwaura, 2016; Muriithi & Waweru, 2017; Rasheed et al., 2018; Issn & Fadun, 2020; John et al., 2020; Isoh & Nchang, 2020). The findings provided sufficient evidence to reject the null hypothesis and established that operational risk management influence the financial performance of banks positively.

Though banks have hitherto paid more attention to the financial risk types (i.e., credit risk, market risk, and liquidity risks), many still do not pay the required attention to operational risk management probably due to inadequate knowledge of its impact on bank's financials. The result of this study further highlights the need for banks to pay careful attention to management and operational risk management as it has an important influence on financial efficiency.

5. Conclusions, Limitations and Future Research and recommendations

5.1 Conclusions

This paper dealt with variables of (ORM) and financial performance in Iraqi commercial banks. It is concluded that banks are a crucial element for the country's economic development, and it is crucial for the Iraqi economic development.

From the analysis, it can be noted that the four independent variables (People risk, System risk, Process risk and External risk) had an impact on commercial banks' financial performance in Iraq.

The study concludes that operational risk management affects commercial banks' financial performance.

Hence, the higher the level of operational risk management implementation, the higher the financial performance.

Directing the attention towards the bank's operational risk management enhances the performance of individuals, organization, and the financial aspect as well. Also, safeguarding the assets of the banks and protect the investors' interests.

Therefore, this paper fills the gap in the literature by providing an understanding of operational risk management to improving financial performance in Iraqi commercial banks.

5.2 Limitations and Future Research

This study is selective and offers opportunities for further studies. However, the study findings are limited by its focus only on the Iraqi commercial banks. Further research could be done in other sectors of the country, such as manufacturing or information technology, to generalize the results of this study or indicate a need to modify the related concepts.

Second, self-reported data were used, possible interference with the survey cannot be ruled out because the respondents' interpretation and answers are not inherently impartial. A future study could use an on-site survey process with a researcher helping the respondent during the questionnaire without guaranteeing that the employees will complete the survey personally.

Third, in this study, there is both an independent and dependent variable. In the future, intermediate or moderate structures may be explored, which we believe will provide additional insights into operational risk management and their impacts on financial performance.

Finally, qualitative research on operational risk management a deeper understanding of how banks manage them is very necessary. Future research will conduct interviews or conduct on-site visits with executives and employees to further explore these activities.

5.3 Recommendations

Based on the above results: therefore, the researchers recommended that:

In order to continue to boost its financial efficiency, banks should tighten up their operational risk management systems.

The Iraqi commercial banks should regularly study and assess their opportunities to achieve their financial objectives. The Bank should also improve its monitoring system in order to avoid some losses.

Author Contributions

The manuscript, collection of data, study, and interpretation of data and reading, and acceptance of the final manuscript were also contributory to all authors. In addition, both writers affirm that the agreement must be made responsible for all aspects of work in ensuring adequate investigation and resolution of questions relating to the quality or credibility of any part of the work.

Disclosure statement

The writers have not identified any possible conflicts of interest.

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